

SUMMARY ANALYSIS OF AMENDED BILL

Author: Haynes Analyst: John Pavalasky Bill Number: AB 411
 Related Bills: See Legislative History Telephone: 845-4335 Amended Date: January 13, 2004
 Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Qualified Equity Investments Or Contributions In Qualified Community Development Entity Credit/California New Markets Venture Capital Program Act of 2004

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

☒ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

☒ AMENDMENTS DID NOT RESOLVE THE DEPARTMENTS CONCERNS stated in the previous analysis of bill as amended March 25, 2003.

☒ FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

☒ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED MARCH 25, 2003 STILL APPLIES.

☒ OTHER – See comments below.

SUMMARY

This bill would enact the California New Markets Venture Capital Program Act of 2004, administered by the Department of Housing and Community Development (DHCD) relating to low or moderate income community development.

SUMMARY OF AMENDMENTS

The January 5, and January 13, 2004, amendments made the following changes:

1. The DHCD replaces the Technology, Trade, and Commerce Agency as the administrator of this program.
2. Each tax credit would begin in 2004 rather than 2003, and would sunset on January 1, 2008.

The PURPOSE OF THE BILL, LEGISLATIVE HISTORY, and OTHER STATES' INFORMATION have not changed from the analysis of the bill as amended March 25, 2003, and still apply. An updated analysis of each of these credits to reflect the amendments as well as a new revenue estimate is provided. These amendments also would make changes to the Government Code. Those changes do not affect the department and are not discussed in this analysis.

Board Position:

_____ S _____ NA _____ NP
 _____ SA _____ O _____ NAR
 _____ N _____ OUA ☒ PENDING

Legislative Director

Date

Brian Putler

2/3/04

EFFECTIVE/OPERATIVE DATE

This bill would become effective January 1, 2005. However, this bill specifies that the tax credits would be applied to taxable years beginning on or after January 1, 2004.

POSITION

Pending.

Summary of Suggested Amendments

Technical amendments are necessary and are provided. In addition, substantive amendments are necessary to resolve implementation and policy concerns. Department personnel are available to work with the author to resolve these concerns and any other issues that arise as the bill moves through the legislative process.

SUMMARY OF ECONOMIC IMPACT

Revenue Estimate Summary

Based on data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact of AB 411 As Amended 1/13/04, Enactment Assumed After 6/30/04 [\$ In Millions]			
	2004-05	2005-06	2006-07
A. Qualified Equity Investment Credit	-\$15	-\$40	-\$65
B. Qualified Contribution Credit at <u>Assumed</u> Levels of Contributions of Land and/or Cash			
\$ 35 Million In Contributions	-\$4	-\$7	-\$7
\$ 60 Million In Contributions	-\$7	-\$12	-\$12
\$110 Million in Contributions	-\$12	-\$22	-\$22

Projected applied "qualified equity investment credits" would increase each year until peaking in 2009 at about \$135 million, and begin declining thereafter. It is anticipated that nearly all qualified equity investment credits would be applied by taxable year 2015. Over 12 years (2004-2015), it is estimated that applied equity investment credits would total roughly \$820 million.

Estimates for the "qualified equity investment credit" have increased somewhat from the March 25, 2003, amendments. Previous estimates were -\$15 million, -\$30 million, and -\$50 million for 2003-04, 2004-05, and 2005-06. Estimates were increased primarily because the second competitive round for the allocation of federal tax credits of up to \$3.5 billion under the New Markets Tax Credit (NMTC) program combines allocations previously designated for 2003 and 2004. This second round of allocations would generate nearly \$1.2 billion (versus the previously projected \$500 million) in qualified equity investments under this proposal in the second year after enactment.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Each of these credits will be discussed separately.

A. Credit For Investments Made In A Qualified Community Development Entity (CDE)

ANALYSIS

FEDERAL/STATE LAW

Current Federal Law General Description

Starting in 2001, federal law allows a NMTC. That credit will enable a CDE to raise investment capital from taxpayers. The CDE will then have the capital to make loans to businesses in low-income communities or directly to low-income persons.

The NMTC available to the investor that holds the stock in the CDE over a seven-year period is as follows:

- a 5% credit for the first three years after the equity interest is purchased from the CDE, and
- a 6% credit for the following four years.

The maximum annual amount of qualifying equity investments eligible for the credit is capped as follows:

<u>Calendar Year</u>	<u>Maximum Qualifying Equity Investment</u>
2001	\$1.0 billion
2002-2003	\$1.5 billion per year
2004-2005	\$2.0 billion per year
2006-2007	\$3.5 billion per year

Current California Law

California law does not conform to the federal NMTC. However, under the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL), California law allows a 20% credit for the amount of each "qualified investment" in a "community development financial institution" (CDFI). For purposes of the 20% state credit, a qualified investment is defined as a deposit or loan that does not earn interest, or an equity investment, that is equal to or greater than \$50,000 and is made for a minimum duration of 60 months. A CDFI is defined as a private financial institution located in California and certified by the California Organized Investment Network (COIN) that has community development as its primary mission and lends in urban, rural, or reservation-based communities in California. A CDFI may include a community development bank, a community development loan fund, a community development credit union, a micro-enterprise fund, a community development corporation-based lender, and a community development venture fund.

California law provides for a recapture of the credit if the qualified investment is reduced or withdrawn before the end of the 60-month period. This CDFI credit will sunset for taxable years beginning on or after January 1, 2007.

In addition, California has four types of economic development areas:

- Enterprise Zones (EZ),
- Local Agency Military Base Recovery Areas (LAMBRA),
- Targeted Tax Area (TTA), and
- Manufacturing Enhancement Areas (MEA).

The following table shows the tax incentives available to each of the economic development areas.

Types of Incentives	EZ	LAMBRA	TTA	MEA
Sales or Use Tax Credit	X	X	X	
Hiring Credit	X	X	X	X
Employee Wage Credit	X			
Business Expense Deduction	X	X	X	
Net Interest Deduction	X			
Net Operating Loss	X	X	X	

THIS BILL

This bill would allow a credit over a four-year period to a taxpayer for a percentage of the amount of cash a taxpayer invests in a qualified CDE. The qualified CDE must have as its primary mission serving or providing investment capital for low-income communities or low-income persons located in California. This California credit language is substantially the same as the federal NMTC except that the CDE must be certified by the state instead of by the U.S. Secretary of the Treasury and the qualified low-income community investments must be made in California to qualify. In addition, low-income communities are defined to only include areas located in California.

The amount of investment that may be designated as eligible for a qualified state credit by a qualified CDE is equal to 100% of the investment allocation that CDE received under the federal new markets allocation for federal purposes. A qualified CDE is required to sell equity interests to investors within five years of the date the entity receives a federal new markets allocation. Any amount not sold within that time period is no longer eligible for the state credit.

If the credit exceeds the tax for the taxable year, the excess may be carried over to reduce the tax in the succeeding years, until the credit is exhausted.

IMPLEMENTATION CONSIDERATIONS

1. Certification by state

This bill in Section 17052.77(b)(1)(A)(iii) requires that the entity be certified by the state as being a qualified CDE, while in Section 23677(b)(1)(A)(iii) the certification is required to be done by the State Treasury. The DHCD is the state agency responsible for administering the California New Markets Venture Capital Program created by this bill. As a result, DHCD would seem to be the appropriate state certifying authority for these credits.

2. Recapture of credits

This bill requires recapture of credits claimed by the taxpayer upon disqualifying events occurring within those certified entities. The taxpayer will not know that one of these recapture events has happened within the entity, and the department would be auditing the taxpayer and not the certified entity. The DHCD, in addition to the initial certification required by this bill, should also be required to monitor:

- investments made by taxpayers in these certified entities, and
- the occurrence of recapture events inside these entities.

The DHCD should be required to notify the department of the names and taxpayer identification information for taxpayers making qualified equity investments as well as the taxpayers impacted by a recapture event within these certified entities.

3. Definition of other services

The definition of qualified low-income community investments includes financial counseling and other services to residents of, and businesses located in, low-income communities located in this state. The use of the term "other services" without a definition could lead to disagreements between the department and the taxpayer claiming the credit. A definition of this term would enable the DHCD to monitor the investments made by the qualified CDE.

4. Certification by CDE of qualified investment

This bill requires the qualified CDE to designate that the investment made by the taxpayer qualifies for the credit. The CDE should also be required to report to the DHCD and the department the names and taxpayer identification information for taxpayers making qualified equity investments in the qualified CDE. This notification would enable the taxpayer to claim the credit for the four-year credit period, absent a recapture event, without the need for an intrusive audit to determine the taxpayer's eligibility for the credit.

5. Notification by CDE of federal allocation

The maximum amount of investment that a qualified CDE can designate as eligible for qualified credits under this bill cannot exceed an amount equal to the federal New Markets Credit investment allocated to the qualified CDE under federal law. The state allocation must be used within five years of receiving that federal allocation. CDE should also be required to report to the DHCD the date and amount of the federal allocation so that the total state credit available and the time limit can be verified by the DHCD.

6. Identification of eligible entities

(a) The bill uses language that is similar but not identical to the federal NMTC. In some cases, these differences in language have no substantive legal effect but could nonetheless lead to taxpayer confusion. For example, federal law identifies eligible entities as corporations and partnerships, while the bill identifies eligible entities as corporations, partnerships, and limited partnerships.

While limited partnerships are required to pay an annual California tax of \$800, for federal purposes and all other California tax purposes, limited partnerships are treated no differently than entities that are partnerships. However, the identification of limited partnerships as eligible entities could confuse taxpayers into erroneously concluding that other entities taxable as partnerships, such as limited liability companies (LLCs), are not eligible entities.

(b) This bill also uses federal terminology that may be interpreted differently under California law. For example, the bill would require that a qualified CDE be a "domestic" corporation or partnership. Under federal law, the term "domestic" means formed in the United States. However, under California Corporations Code Section 167, a domestic corporation means a corporation formed under the laws of California. A requirement that a qualified CDE be a "domestic" corporation or partnership may be subject to constitutional challenge under the Commerce Clause of the United States Constitution. Since the investments made by a qualified CDE are required to be made "in this state" in order for a taxpayer to receive a credit under this bill, it could be argued that the requirement that a qualified CDE be a "domestic" corporation or partnership is unnecessary.

TECHNICAL CONSIDERATIONS

1. The term "qualified low-income community investments" is defined in the bill. However, in two instances (once in Section 17052.77(b)(2)(B) and once in Section 23677(b)(2)(B)) part of the phrase was omitted. Amendments 1 and 5 are provided to resolve this issue.
2. The phrase "in this state" was omitted in two places in the bill (once in Section 17052.77(b)(4)(B) and once in Section 23677(b)(4)(B)). Amendments 2 and 6 are provided to resolve this issue.
3. The bill contains two references to federal terminology rather than state terminology. Amendments 3 and 7 are provided to resolve this issue.
4. In two instances (once in Section 17052.77(f) and once in Section 23677(f)), the term "this subdivision" is used where the term being defined is not in "this subdivision." Amendments 4 and 8 are provided to resolve this issue.

FISCAL IMPACT

If the implementation considerations addressed in this analysis are resolved, the department's costs are expected to be minor.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact of AB 411 As Amended 1/13/04, Enactment Assumed After 6/30/04 [\$ In Millions]			
	2004-05	2005-06	2006-07
Qualified Equity Investment Credit	-\$15	-\$40	-\$65

Projected applied “qualified equity investment credits” would increase each year until peaking in 2009 at about \$135 million, and begin declining thereafter. It is anticipated that nearly all qualified equity investment credits would be applied by taxable year 2015. Over 12 years (2004-2015), it is estimated that applied equity investment credits would total roughly \$820 million.

Estimates for the “qualified equity investment credits” have increased somewhat from the March 25, 2003, amendments. Previous estimates were -\$15 million, -\$30 million, and -\$50 million for 2003-04, 2004-05, and 2005-06. Estimates were increased primarily because the second competitive round for the allocation of federal tax credits of up to \$3.5 billion under the NMTC program combines allocations previously designated for 2003 and 2004. This second round of allocations would generate nearly \$1.2 billion (versus the previously projected \$500 million) in qualified equity investments under this proposal in the second year after enactment.

Revenue Discussion

The revenue impact of this provision of the bill would be determined by amounts of (1) federal allocations of NMTCs, (2) qualified equity investments, and (3) tax credits that can be applied to reduce tax liabilities.

In the first quarter of 2003, the federal government announced 66 CDEs had been selected to receive allocations of NMTCs totaling \$2.5 billion through the federal NMTC Program. Of these 66 CDEs, 20 were California-based. These 20 received allocations totaling over \$1 billion, or approximately 42%. These organizations were selected through a competitive application and rigorous review process. Geographic diversity is not a consideration in the evaluation process. For purposes of this revenue analysis, an assumption must be made as to the portion of future annual allocations received by California-based CDEs. Assuming California-based CDEs continue to be very competitive in the application and review process, it is projected that California-based CDEs will receive future annual allocations averaging one-third of total federal allocations.

Qualified equity investments were estimated by tracking potential future allocations of federal credits by vintage and assuming qualified CDEs market their allocated credits for qualified equity investments within a period of five years. Qualified equity investments are assumed spread over the five years using sum-of-the-years'-digits (i.e., 5/15 in the first year, 4/15 in the second, etc.). Proposed credit percentages were applied to each year's projected qualified equity investment for the four-year credit period. For each taxable year, credits are summed and it is assumed three-quarters of total potential credits would be applied to reduce tax liabilities each year.

ARGUMENTS/POLICY CONCERNS

1. Duplication of credits

This bill would create a credit that is claimed by the taxpayer investor in each of four years beginning with the year of the initial investment. One provision of the bill allows a subsequent investor to qualify for this credit if the investment was a qualified investment to the original investor. However, there are no provisions to prevent the original investor from continuing to take the credit for the full four years and also have the subsequent investor qualify to claim the credit as well. The comparable federal credit, however, requires that the investment be held on the credit allowance date (i.e., the date the investment is initially made and on each of the six anniversary dates after the date of the initial investment) by the taxpayer in order to claim the credit. The author may wish to specify rules similar to the federal rules for the transfer of eligibility to claim this California credit from the original investor to the subsequent investor so that the credit is claimed by only one investor in each of the four years beginning with the year of the initial investment.

2. Valuation of gross assets

This credit requires the qualified CDE to invest at least 85% of its aggregate gross assets in qualified low-income community investments, which means they have to be located in California. And the recapture mechanisms insure that this requirement will be met. But how is the 85% test applied in situations where the value of the CDE's investments temporarily decline to below 85%, even though more than 85% were originally invested in California businesses? (Since these are equity investments, this is not unlikely.) How will the value of these investments be determined?

3. CDE making investments outside of California

The maximum California investments eligible for credits that can be designated by a qualified CDE are equal to 100% of the amount of the investments allocated to the entity for credit under federal law for community development in the United States. If the CDE is doing business in states other than California, the bill does not reduce the federal allocation to target the amount of federal investment in California. The author may wish to provide a limitation on the maximum California credits available for designation based on the amount of investments made in California for a qualified CDE making investments both within and outside of California.

B. Credit For Contributions Of Property, Easements On Property, Or Money To A Nonprofit Housing Or Community Development Organization.

ANALYSIS

FEDERAL/STATE LAW

Current Federal Law

Existing federal law allows a credit equal to 5% of contributions made in each of 10 taxable years, up to a maximum \$2 million for each corporate taxpayer, to community development corporations, but not for investments in a CDFI. The federal Secretary of Housing and Urban Development is allowed to select up to 20 eligible corporations. At least eight of the operational areas of the corporations selected are required to be rural areas. The selections for the federal credit could not be made on or after July 1, 1994.

Current State Law

Existing state law has not conformed to the federal credit for contributions to a community development corporation. However, under the PITL and the CTL, California law allows a 20% credit for the amount of each “qualified investment” in a CDFI.

For purposes of the 20% state credit, a qualified investment is defined as a deposit or loan that does not earn interest, or an equity investment, that is equal to or greater than \$50,000 and is made for a minimum duration of 60 months. A CDFI is defined as a private financial institution located in California and certified by the California Organized Investment Network (COIN) that has community development as its primary mission and lends in urban, rural, or reservation-based communities in California. A CDFI may include a community development bank, a community development loan fund, a community development credit union, a micro-enterprise fund, a community development corporation-based lender, and a community development venture fund.

California law provides for a recapture of the credit if the qualified deposit is reduced or withdrawn before the end of the 60-month period. This CDFI credit will sunset for taxable years beginning on or after January 1, 2007.

In addition, California has four types of economic development areas. The following table shows the tax incentives available to each of the economic development areas.

Types of Incentives	EZ	LAMBRA	TTA	MEA
Sales or Use Tax Credit	X	X	X	
Hiring Credit	X	X	X	X
Employee Wage Credit	X			
Business Expense Deduction	X	X	X	
Net Interest Deduction	X			
Net Operating Loss	X	X	X	

A partner’s interest in a partnership is generally defined as the manner in which the partners have agreed to share the economic benefits and burdens related to the income, gain, loss, deduction, or credit allocated. A partner with a 50% overall interest in a partnership may have a 90% interest in a particular item of income or deduction. All partners’ interests in a partnership are presumed equal (determined on a per capita basis). The determination of a partner’s interest in a partnership is based on all the facts and circumstances relating to the economic arrangements of the partners. Arrangements that lack substantial economic effect are ignored.

THIS BILL

This bill would allow a credit equal to 20% of the cash or 20% of the fair market value of California real property (including a perpetual interest) contributed to a qualified donee (QD).

A qualified contribution would mean a contribution of cash or real property or a perpetual interest in real property. Real property that is to be contributed may be developed or undeveloped and must meet the following criteria:

- The real property must be located in California.
- At the time the real property is contributed, the taxpayer cannot be mandated by a local agency to provide affordable or low-income housing.
- The real property must be approved for acceptance by a QD.

The QD is required to approve that donation prior to its being made and provide a signed certification to the contributor containing:

- A description of the qualified property (including its parcel number and location, if any);
- The name of the taxpayer making the contribution; and
- The name and address of the QD.

The taxpayer would be required to provide a copy of that certification to the FTB upon request.

The bill would define a QD as a nonprofit corporation, including a land conservancy or land trust established in California that has as its principal purpose to enable ownership, development, or management of housing or community development projects for disadvantaged persons.

If a pass-through entity makes a qualified contribution, the fair market value of the contribution must be passed through to the owners in accordance with their interest in the pass-through entity, determined as of the date of the contribution. Pass-through entity is defined to include any estate, trust, partnership, or S corporation. Because a particular partnership interest (e.g., ownership, percentage of profits or losses) is not specified, the partnership interest that would apply would be the ownership interest.

This bill specifies that this credit is in lieu of any other credit or deduction that the taxpayer may otherwise claim with respect to the qualified contribution.

If the credit exceeds the tax for the taxable year, the excess may be carried over to reduce the tax in the succeeding years, until the credit is exhausted.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

1. The bill specifies that real property or a perpetual interest in real property may be a qualified contribution. The bill does not specify any other types of interests in real property that may be donated to receive a credit, such as an easement or leasehold. An interest in land can be sold, transferred, or otherwise disposed of in several different ways (e.g., future or remainder interest). To avoid confusion, the author may desire to specify what types of interests in the property must be donated. Additionally, the term "perpetual interest" is not defined.
2. The bill does not provide any conditions to ensure that the land donated could not be converted to another use by the QD.
3. The term "fair market value" needs to be clarified. Consideration should be given to clarifying whether the fair market value refers to the fair market value of the land used for affordable housing or for the land's potential highest and best use.
4. Under the bill, the QD must have been organized for the principal purpose of enabling ownership, development or management of housing or community development for individuals who are disadvantaged, have a transitional need, have a low income, or members of a targeted group. However, the terms "community development," "disadvantaged," "transitional need," and "low income" are not defined.
5. The bill provides special rules for contributions by pass-through entities.
 - A. General rules already provide that credits flow through partnerships and are claimed by partners in accordance with the partnership agreement. It is unclear why the bill provides a special rule that the fair market value (FMV) of the contribution flows through to the owners of the pass-through entity. If it is intended that this special rule apply regardless of the partnership agreement, the author may wish to define whether "partnership interest" means the ownership interest or the profit/loss interest.
 - B. The bill defines pass-through entities to include estates and trusts. Estates and certain trusts are subject to state tax on net income and are not normally considered pass-through entities. The assets of a trust are "owned" by a trustee for the benefit of other persons. The assets of an estate are owned by a fiduciary during the period of administration. It is unclear which "owners" of these entities would be entitled to the credit. The author may wish to consider deleting estates and trusts from the definition of pass-through entity.
6. This bill does not limit the number of years for the carryover period. The department would be required to retain the carryover on the tax forms indefinitely because an unlimited credit carryover period is allowed. Recent credits have been enacted with a carryover period limitation since experience shows credits typically are exhausted within eight years of being earned.

FISCAL IMPACT

If the implementation considerations addressed in this analysis are resolved, the department's costs are expected to be minor.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact of AB 411 As Amended 1/13/04, Enactment Assumed After 6/30/04 [\$ In Millions]			
	2004-05	2005-06	2006-07
Qualified Contribution Credit at <u>Assumed</u> Levels of Contributions of Land and/or Cash			
\$ 35 Million In Contributions	-\$4	-\$7	-\$7
\$ 60 Million In Contributions	-\$7	-\$12	-\$12
\$110 Million in Contributions	-\$12	-\$22	-\$22

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The revenue impact of this provision would be determined by the FMV of qualified contributions to QDs and the amount of credits that would be applied to reduce tax liabilities. The level of qualified contributions in any future year is unknown. For purposes of an estimate, three possible fair market value contribution amounts were assumed.

As this provision is nearly identical to a previous bill, the three possible FMV contribution amounts indicated above are from the revenue analysis for SB 553 as amended April 16, 2001. For 2004, it is assumed that qualified contributions would be made during the last half of the year due to enactment after June 30. It is further assumed that most taxpayers contributing real property under this provision would have held the property for substantial time and would not have sold or otherwise donated the real property except for the combined incentive provided by this bill and current federal law. Thus, the amount of gains that would otherwise have been reported on sales of the property is unknown, but not expected to be particularly significant.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 411
As Amended January 13, 2004

AMENDMENT 1

On page 19, line 32, after "low-income" insert:
community

AMENDMENT 2

On page 20, line 19, after "investment" insert:
in this state

AMENDMENT 3

On page 22, line 9, strikeout "chapter" and insert:
part

AMENDMENT 4

On page 22, line 11, strikeout "subdivision" and insert:
section

AMENDMENT 5

On page 28, line 37, after "low-income" insert:
community

AMENDMENT 6

On page 29, line 24, after "investment" insert:

in this state

AMENDMENT 7

On page 31, line 15, ~~strikeout "chapter"~~ and insert:

part

AMENDMENT 8

On page 31, line 17, ~~strikeout "subdivision"~~ and insert:

section